RESEARCH

MELBOURNE CBD

OFFICE MARKET OVERVIEW **MARCH 2016**

HIGHLIGHTS

Along with Sydney, the Melbourne CBD office market is projected to record below average vacancy rates over the next two years with supply currently under construction well below the historical average.

Underpinned by non-CBD tenants migrating into the CBD, net absorption reached eight-year high levels; driving a five-year high prime effective rental growth rate.

Melbourne continues to be a focal point for global investors having attracted the 11th highest level of cross-border office investment in 2015, globally.

KEY FINDINGS

CBD total vacancy fell to its lowest level in three years down from 9.1% to 7.7% over the 12 months to January 2016

Gross CBD office **supply is forecast to remain below the historical average** over the next three years

Reflecting the declining vacancy rate, **average prime effective rents grew at their strongest rate in five years**

US-based groups accounted for 54% of cross-border investment into the Melbourne CBD office market in 2015

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SUPPLY & DEVELOPMENT

Gross CBD office supply is forecast to remain below the historical average over the next three years which will further aid the decline in vacancy.

Gross CBD office supply totalled 45,069m^2 in the six months to January 2016, wholly as a result of the completion of 567 Collins Street which was completed in July 2015. The level delivered to the CBD office market was 33% below the average recorded over the past 10 years (67,596m^2 per six monthly period).

Interestingly, despite the proliferation of residential development of former office buildings, only 929m^2 was withdrawn from the CBD office market in the six months to January 2016, the lowest level in seven years. As a result of the low level of withdrawals, on a net basis the CBD stock levels increased higher than average in the second half of 2015.

Looking forward, over the next two years 44,223m^2 is expected to be permanently withdrawn, largely for residential development. In addition, a further 50,000m^2 of CBD office space is forecast to be temporarily withdrawn for refurbishment over the same period.

With only three developments currently under construction with a NLA in excess of 10,000m^2; over the next three years, gross supply added to the market will average 2.1% of total stock per annum, well below the historical annual gross supply average of 3.6% of stock.

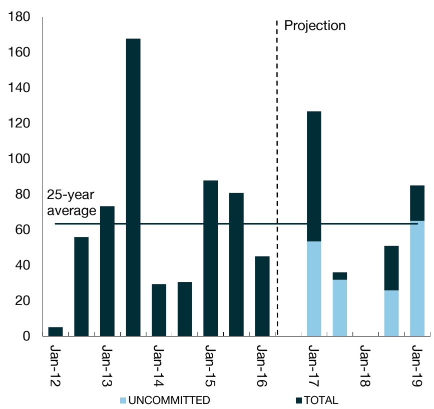
The next scheduled completions are two new office buildings at Walker Corporation's Collins Square precinct in the Docklands. Tower 4 (40,000m^2) and Tower 2 (70,000m^2) are scheduled for completion later this year. Of the space that is under construction, 61% is pre-committed, leaving just 54,200m^2 uncommitted. A further 102,400m^2 of backfill and refurbished space is also forecast to be delivered to the market over the same time frame.

Developments which are expected to commence construction soon include: Lend Lease's One Melbourne Quarter (25,000m^2) and ISPT's 271 Spring Street (20,000m^2) which is awaiting development approval to proceed.

FIGURE 1

Gross Supply & Commitment

CBD Office (000's m^2)



Source: Knight Frank Research/PCA

TABLE 1

Melbourne CBD Office Market Indicators as at January 2016

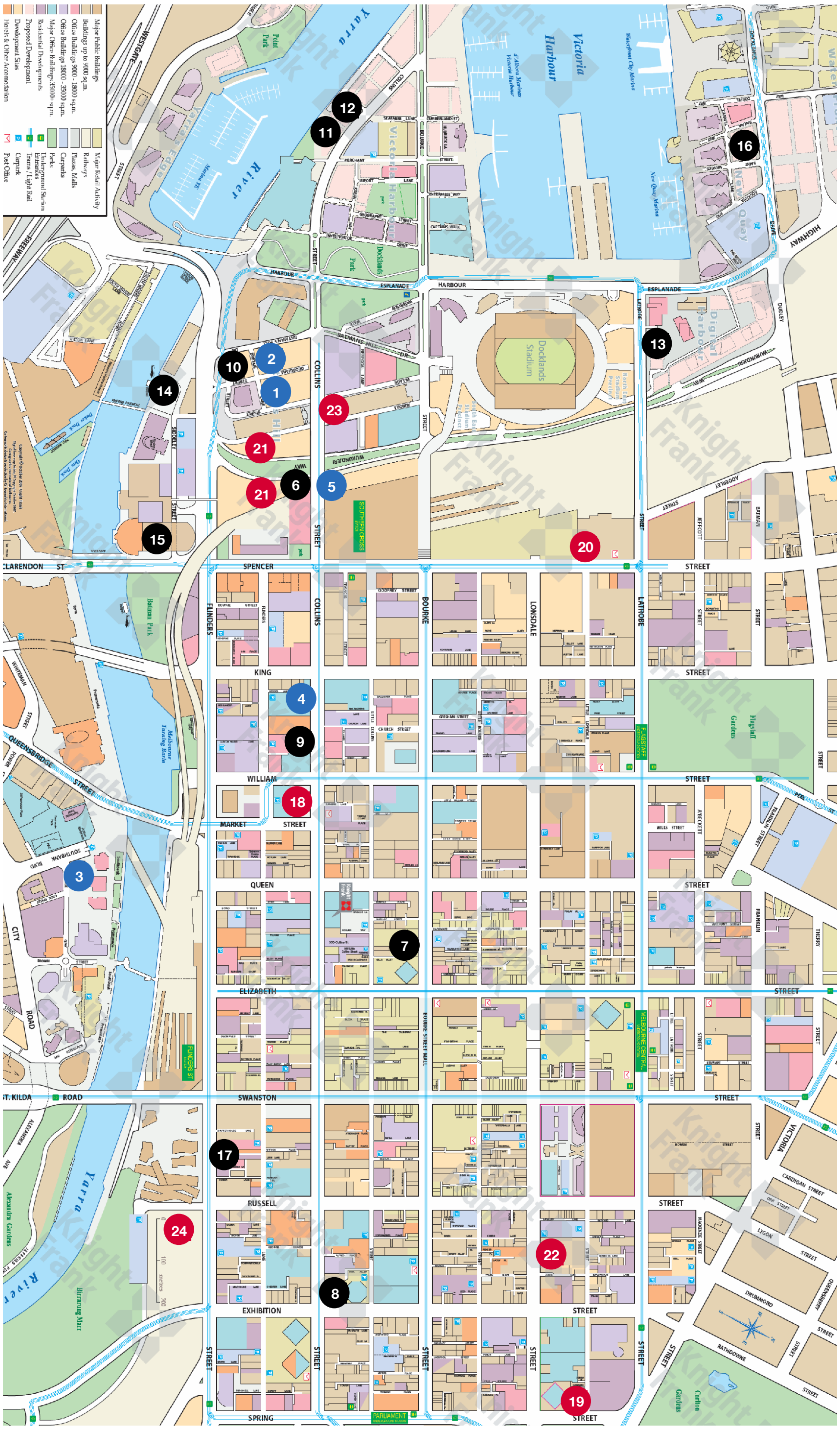
Grade	Total Stock (m²)	Vacancy Rate (%)	Annual Net Absorption (m²)	Annual Net Additions (m²)	Average Net Face Rent ($/m²)	Average Incentive (%)	Average Core Market Yield (%)
Prime	2,903,366	7.4	113,529	109,056	480—670	25.0—30.0	4.75—6.50
Secondary	1,554,086	8.3	3,234	-48,596	300—420	27.0—33.0	5.75—7.25
Total	**4,457,452**	**7.7**	**116,763**	**60,460**			

Source: Knight Frank Research/PCA

NB. Average data is on a weighted basis

MAJOR OFFICE SUPPLY

1. 2 Collins Sq - 70,000m² [KPMG/Maddocks/AECOM] Walker - Q3 2016 - 55% committed.
2. 4 Collins Sq - 40,000m² [Link Group/Deakin Prime] Walker - Q4 2016 - 76% committed.
3. 2-4 Riverside Quay ^ - 20,100m² [PwC] Mirvac/ISPT - Q4 2016 - 100% committed.
4. 525 Collins St - 6,000m² [Bank of Melbourne] St Martins/Equiset - Q2 2017 - 50% committed.
5. 664 Collins St - 25,800m² [Pitcher Partners] Mirvac - Q2 2018 - 39% committed.
6. One Melbourne Quarter - 25,000m² [Arup/Lend Lease] Lend Lease - Q2 2018 - 60% committed.
7. 405 Bourke St - 61,000m² Brookfield - 2020+
8. 80 Collins St - 43,000m² Queensland Investment Corporation (QIC) - 2019+
9. 477 Collins St - 51,000m² Mirvac - 2020+
10. 5 Collins Sq - 40,000m² Walker - 2018+
11. Y3, 839 Collins St - 39,200m² Lend Lease - 2019+
12. Y4, 855 Collins St - 34,000m² Lend Lease - 2019+
13. 1000 Latrobe St - 32,500m² Digital Harbour - 2019+
14. North Wharf - 20,000m² WTC Asset Management - 2020+
15. 601 Flinders St - 60,000m² Eureka/Asset 1 - 2020+
16. 395 Docklands Dve - 22,000m² MAB - 2019+
17. 180 Flinders St - 20,000m² DEXUS - 2019+
18. 447 Collins St - 50,000m² Cbus Property - 2020+
19. 271 Spring St - 20,000m² ISPT - 2018+
20. 311 Spencer St - 55,000m² Australia Post/Cbus Property - 2020+
21. Melbourne Quarter - 110,000m² Lend Lease - 2020+
22. 124-148 Lonsdale St - 55,000m² Uniting Church/Charter Hall - 2019+
23. 710 Collins St - 47,500m² Abacus Property Group - 2020+
24. Fed Square East - 60,000m² State Government - 2020+



Source of Map: Knight Frank Research

- Under Construction / Complete
- DA Approved / Confirmed / Site Works
- Mooted / Early Feasibility

NB. Dates are Knight Frank Research estimates
Major tenant precommitment in [brackets] next to NLA
^ Southbank precinct
Office NLA quoted

TENANT DEMAND & RENTS

The improvement in the labour market has been the greatest in NSW where the unemployment rate has dipped to a national low of 5.2% and the state's pace of employment growth is a very robust 4.4% over the year which is consistent with a rebalancing of growth away from resources and towards services. This was also seen in Victoria, albeit to a lesser extent, where employment growth is running at a 2.6% pace.

According to the Australian Bureau of Statistics, over 12 months to November 2015, Victorian employment growth was largely driven by the health care, construction and professional services sectors. In terms of traditional white collar employment, these sectors also appear to be improving with the finance and professional services sectors both rebounding having contracted over 2014. Public services employment however was muted with total employment contracting by 10,000 employees over 2015. In the year to November 2015, Victorian employment increased by 3.1%, its fastest growth rate since 2000.

Similar to population growth, Victoria recorded the largest annual increase in business counts in the year to June 2015. The greatest growth of Victorian-based businesses over the year to June 2015 was those employing less than 20 employees, while encouragingly the number of business employing more than 200 employees also grew.

TABLE 2
Melbourne CBD Vacancy Rates

Grade	Jan-15 (%)	Jul-15 (%)	Jan-16 (%)
Premium	8.4	7.2	10.3
A Grade	7.7	7.6	6.5
Prime	**7.9**	**7.5**	**7.4**
B Grade	12.5	9.4	8.3
C Grade	11.3	10.0	9.4
D Grade	2.0	3.0	2.4
Secondary	**11.3**	**9.1**	**8.3**
Total	**9.1**	**8.1**	**7.7**

Source: Knight Frank Research/PCA

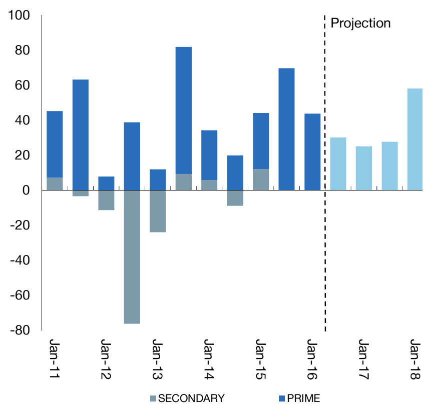
The Melbourne CBD office market continued to strengthen over the six months to January 2016 with the overall vacancy rate falling from 8.1% to 7.7%. Melbourne continues to host the second lowest vacancy rate amongst all of Australia's CBDs.

Emulating Australia's economic transition, net absorption recorded in the six months to January 2016 within the Melbourne and Sydney CBD office markets accounted for 90% of all space absorbed across the Australian CBD office markets. In the six months to January 2016, net absorption in the Melbourne CBD office market totalled 55,897m^2, equating to 116,763m^2 absorbed over 2015.

The above-average levels of net absorption recorded in the Melbourne CBD office market continues to be predominantly driven by non-CBD tenants migrating into the market. Knight Frank Research analysis reveals that 79.4% of the net absorption over 2015 recorded in the Melbourne CBD office market was attributed to migrating tenants. Tenants who migrated into the CBD office market over 2015 included: Victoria Police from St Kilda Road, NEC from Mulgrave, Jemena from Mt Waverley and VECCI from East Melbourne.

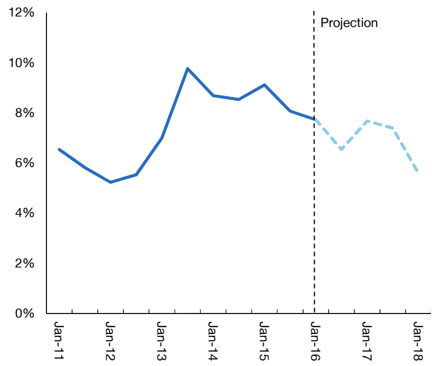
Interestingly, the vast majority of the relocations made by migrating tenants

FIGURE 2
Melbourne CBD Net Absorption
per six month period (000's m^2)



Source: Knight Frank Research/PCA

FIGURE 3
Melbourne CBD Vacancy Rate
Total Vacancy (%)



Source: Knight Frank Research/PCA

were into prime quality office space with Premium and A-grade accounting for 80.7% the total office space absorbed by migrating tenants in 2015. With the unemployment rate appearing to have peaked for the short term, increasingly tenants are less focused on occupancy costs and more attentive to the attraction and retention of staff with the quality of workplaces a tenant driver. As a result of this trend of tenants upgrading their office accommodation, Premium and A-grade net absorption totalled 43,792m^2, accounting for 78% of the office space absorbed in the six months to January 2016. Despite the flight to quality trend observed in the Melbourne CBD office market, secondary grade office space recorded net absorption of 12,065m^2 in the six months to January 2016, the highest level recorded in seven years. As a result of this positive net absorption, the secondary office vacancy rate has fallen to its lowest level since January 2013.

Sublease vacancy in the Melbourne CBD office market fell marginally from 1.1% in July 2015 to 0.9% as at January 2016. Whilst the headline sublease vacancy rate is expected to continue to decline over 2016 with a number of tenant commitments imminent, there remains a component of hidden sublease vacancy with additional space being actively marketed for sublease but not physically vacant.

Anticipated Vacancy Levels

Looking ahead, job advertisements continue to rise in Australia registering a 10.8% increase over the year to January 2016, confirming the broader cyclical upswing in hiring intentions that has been evident since early 2014. White collar employment growth in the Melbourne CBD office market is expected to continue to expand. Having grown by 3.4% in 2015, white collar employment is forecast to increase by 1.4% or 4,036 employees over the coming year. Over the next three years white collar employment growth in the Melbourne CBD office market is forecast to be driven by growth in the Professional Services, Government and Accommodation & Food sectors.

With white collar employment predicted to continue to increase, coupled with the absence of any major developments scheduled for completion until mid 2016, total vacancy in the CBD office market is forecast to decline over the first half of 2016. After declining to 6.5% in July 2016, following the new supply delivered at Collins Square and major refurbishments, vacancy is expected to rise to 7.7% before trending down through 2017 and 2018.

Rental Levels

With CBD total vacancy falling from 9.1% to 7.7% over 2015 and to its lowest level in three years, average prime effective rents grew at their strongest rate in five years. In the 12 months to January 2016, average prime effective rents increased by 4.3% to $355/m^2 net. While average prime incentives range between 25% and 30%, for the first time in five years, average incentives have declined, albeit marginally. In addition to the decline of average incentives, the growth of prime effective rents was enhanced by a face rental increase of 3.3% over the year.

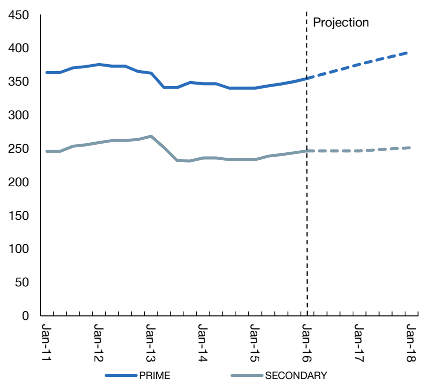
After two consecutive years of declines in secondary effective rents; underpinned by face rental growth, average secondary rents grew at their strongest rate in three years. In the 12 months to January 2016, average secondary effective rents increased by 5.7% to $246/m^2 net. Although secondary effective rents grew, average secondary incentives continue to range between 27% and 33%.

With vacancy to trend down over the next three years prime net face rent levels are forecast to record average growth of 5.0% per annum with secondary net face rents to record average annual growth of 2.3% over the next three years.

FIGURE 4

Average Net Effective Rents

Melbourne CBD ($/m^2)



Source: Knight Frank Research

TABLE 3

Recent Leasing Activity Melbourne CBD

Address	Precinct	NLA (m^2)	Term (yrs)	Lease Type	Tenant	Sector	Start Date
One Melbourne Quarter	Docklands	6,000	U/D	Precom	Arup	Business Services	Q2-18
570 Bourke Street	Western	2,757	10	New	JLT Australia	Finance & Insurance	Q4-16
171 Collins Street	Civic	3,220	7.5	Sublease	Guild Insurance*	Finance & Insurance	Q3-16
101 Collins Street	Eastern	2,168	U/D	New	Guardian Childcare	Health Care	Q3-16
570 Bourke Street	Western	8,782	12	New	VLA	Legal	Q2-16
367 Collins Street	Western	1,115	7	New	Bensons Property	Real Estate	Q2-16
818 Bourke Street	Docklands	3,815	10	New	ABS	Government	Q2-16
440 Collins Street	Western	2,500	1	New	Energy Australia	Utilities	Q1-16
277 William Street	Flagstaff	960	5	New	Danford College	Education	Q1-16
720 Bourke Street	Docklands	1,341	7	New	CASA	Government	Q1-16
120 Spencer Street	Spencer	6,100	10	New	Sage Institute of Education	Education	Q4-15
459 Collins Street	Western	850	5	New	Synchronoss	TMT	Q4-15
114 William Street	Western	939	5	New	Gravity Co-Working	Real Estate	Q4-15
720 Bourke Street	Docklands	1,578	7	New	Chubb Insurance	Finance & Insurance	Q4-15
120 Collins Street	Eastern	1,377	7	New	Crestone	Finance & Insurance	Q4-15

*Tenant relocating to CBD   TMT refers Technology Media & Telecommunications   U/D refers undisclosed

Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

Investment interest in the Melbourne CBD remained strong in 2015, with sale volumes achieving the second highest annual level on record. Office investment sales activity ($10m+) in 2015 within the Melbourne CBD totalled $2.86 billion across 30 properties. While 2015 was $362 million below the record levels achieved in 2014, 2015's levels were still 70% higher than the 10-year CBD sales volume average.

Cross-border investment into the Melbourne CBD continued to gather momentum, achieving record high levels for the past three consecutive years. Offshore groups dominated CBD office purchases in 2015 accounting for 82% of sales by value. The proportion of transactions acquired by offshore investors in 2015 was substantially higher than previous years, almost doubling the previous high of 42% recorded in 2011.

While Asian-based purchasers bought more assets; US-based groups accounted for 54% of cross-border investment into the Melbourne CBD office market as a result of several large transactions.

Melbourne continues to be a focal point for global investors having attracted the 11th highest level of cross-border office investment in 2015, globally, having been ranked 7th in 2014.

Transactional levels were also boosted by a number of major sales with five transactions above $200 million recorded in 2015, the highest number on record for an individual year. CIC's purchase of the IPG portfolio also included a 50% interest in 120 Collins Street which was valued in excess of $300 million.

Interestingly, private investors were the second most active purchasers of Melbourne CBD office property in 2015. Private investors purchased six CBD offices, totalling $233.5 million, their highest level of spending since 2010.

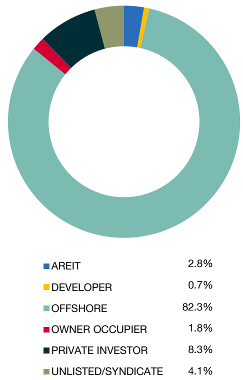
Investors remained centred on prime grade assets, with Premium and A-grade assets accounting for 73% of sales volume or $2.06 billion, the highest level on record.

While prime assets accounted for the majority of investment volume, 21 secondary CBD offices transacted over the year totalling $761.2 million, the fourth highest investment volume on record.

FIGURE 5

Melbourne CBD sales by purchaser

$10 million+ sales — 2015



Source: Knight Frank Research

TABLE 4

Recent Sales Activity Melbourne CBD

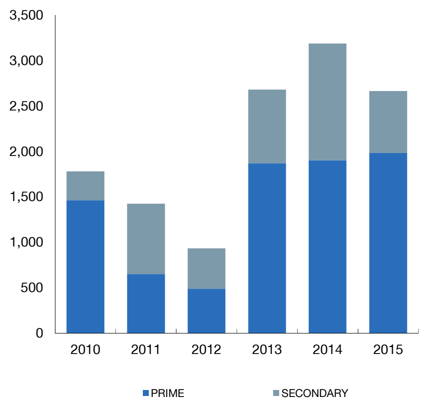
Address	Price ($ mil)	Core Mkt Yield (%)	NLA (m^2)	$/m² NLA	WALE (yrs)	Vendor	Purchaser	Sale Date
533 Little Lonsdale St	35.25	6.00*	6,599	5,299	2.8	Vantage Property	Fidinam (Aust)	Mar-16
1 Collins St	125.00	5.20*	14,006	8,925	3.1	Overland Properties	Harry Stamoulis	Feb-16
406 Collins St	23.10	4.43*	3,742	6,173	N/A	Private Investor	Private Investor	Jan-16
55 King St	78.50	5.84*	12,666	6,198	3.6	LaSalle Asia Opportunity Fund IV (LAOF IV)	Charter Hall (CHOF)	Dec-15
380 Docklands Dr	80.40	N/A	14,800	5,432	N/A	Fitzpatrick Investments	LaSalle Investment Management	Dec-15
520 Bourke St	25.03	4.07*	5,717	4,377	N/A	Offshore Investor	Fife Capital	Dec-15
SX1 & SX2: 181 Exhibition St & 111 Bourke St	675.00	5.12	126,825	10,640	4.8	Brookfield Prime Property Fund	Blackstone Group	Nov-15
277 William St	45.90	N/A	9,870	4,650	3.5	Harry Stamoulis	EG Funds Managament	Nov-15
161 Collins St	275.00	7.70*	43,436	6,331	N/A	SachsenFonds	Pembroke Real Estate	Oct-15
244-248 Flinders St	23.80	N/A	3,391	7,019	N/A	Yooralla Society of Victoria	Offshore Investor	Oct-15
425 Collins St	39.00	5.58	5,390	7,236	2.6	Halim Group	AMP Wholesale Australian Property Fund	Sep-15
460 Lonsdale St	98.00	6.00	11,350	8,634	5.9	REST	Najee Holdings	Aug-15

Source: Knight Frank Research * initial yield ‡ bought for potential residential redevelopment

FIGURE 6

Melbourne CBD Sales $10 million+

By grade ($m)



Source: Knight Frank Research

Similar to the trends of the broader CBD office market, offshore groups led all other buyers of secondary CBD offices followed by private investors.

Despite the intense competition, investors were focused on Core asset purchases with the volume of CBD offices purchased for development continuing to fall. Having peaked in 2013, offices purchased for redevelopment totalled $162.3 million, down from $287.3 million transacted in 2014.

While offshore investors remained a net buyer of CBD office in 2015, offshore groups were the largest sellers of CBD office property with RREEF and SachsenFonds (both German-based) examples of two foreign investors who divested major CBD assets in 2015. In contrast, local institutions (AREITs, unlisted and superannuation funds) were all net sellers in 2015.

2016 has also begun strongly with $273.35 million already having transacted in the first quarter. The level of sales activity already achieved in the first quarter of 2016 has already outweighed those recorded in the first quarter of 2015. The largest transaction of 2016 to date was the sale of 1 Collins Street for $125.0 million to a local private investor.

The significant weight of capital seeking Melbourne CBD office investments coupled with the positive rental outlook has resulted in the yield compression of both prime and secondary yields.

The half share sale of the A-grade SX office complex (181 Exhibition Street and 111 Bourke Street), having transacted on a core market yield 5.12%, demonstrates the significant compression of prime asset yields over the past 12 months.

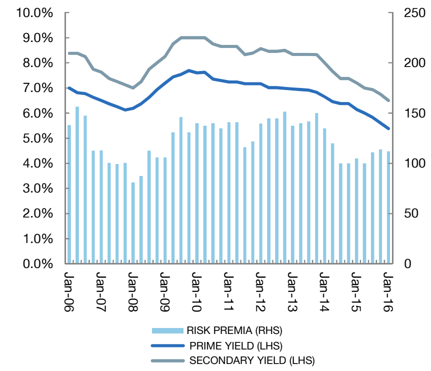
As at January 2016, average prime office yields compressed by 77 basis points to 5.38% and range between 4.75% and 6.50%. Average prime yields now stand 139 basis points lower than the 10-year average.

Although transactional volume of secondary assets did not match the record levels set in 2014, average secondary yields also tightened considerably over 2015. Average secondary yields compressed by 70 basis points in 2015 to range between 5.75% and 7.25%. Similar to prime CBD yields average secondary yields have fallen below their 10-year average with

FIGURE 7

Melbourne CBD Yields & Risk Spread

Core Market Yields & Prime vs Secondary Spread (bps)



Source: Knight Frank Research

the risk spread between prime and secondary assets also slightly narrower than the 10-year average.

Outlook

- With business investment having strengthened over 2015, aided by the lower Australian dollar, Victorian employment increased by 3.1%, its fastest growth rate since 2000. The Victorian economy is forecast to grow by 1.2% in 2016 and on average by 2.4% per annum over the next five years.
- Over the next three years, white collar employment within the CBD is forecast to grow by 20,201 employees. White collar employment growth in the Melbourne CBD office market is forecast to be driven by growth in the Professional Services, Government and Accommodation & Food sectors. In addition to the traditional white collar employment sectors, demand for office space in the CBD from Educational and Technology-based tenants continues to gather momentum.
- Over the next three years, gross supply added to the market will average 2.1% of total stock per annum, well below the historical annual gross supply average of 3.6%. Of the space that is under construction, 61% is already pre -committed.
- Although the Melbourne CBD office vacancy rate is forecast to increase over the second half of 2016, total vacancy is not projected to exceed its current level of 7.7%.
- With vacancy forecast to remain below the historical average over the next three years, further gains in rents are projected. Supported by positive net absorption, prime net face rent levels are forecast to average a growth of 5.0% per annum with secondary net face rents to record average growth of 2.3% over the next three years.
- Whilst 2016 has begun strongly with prime and secondary yields both lower than their 10-year averages, only marginal further compression is anticipated.

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